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SUBJECT: TURBULENCE HITS PARAGUAY'S AVIATION INDUSTRY

¶11. (SBU) SUMMARY: Despite low passenger volumes and unprofitable conditions, several airlines are expanding operations to Paraguay. Regional politics, as opposed to market realities, drive their decisions. Additionally, concerns over Bolivia's nationalization of key industries prompted one airline to shift assets to Paraguay. The International Civil Aviation Organization (ICAO) expressed concern over the safety of Paraguay's airports and may issue an advisory opinion in 2008 warning member countries of these safety issues. TAM Mercosur airline executives demanded that DINAC, Paraguay's aviation regulatory agency, repair key airport infrastructure and equipment, but lax security controls -- exacerbated by corruption and bribes -- expose Paraguay's airports to security threats by terrorists, armed robbers, and traffickers. While DINAC submitted a plan to the Finance Ministry to upgrade its airports and allow flights to the United States, the upcoming election season could increase interest in the airports' deficiencies and give DINAC an opportunity to improve airport safety. END SUMMARY.

CONGESTION IN THE AIRLINE INDUSTRY

¶12. (U) Paraguay has two ICAO-monitored international airports, Asuncion's Silvio Pettirossi International Airport, and Ciudad del Este's (CDE) Guarani International Airport, as well as several small, unregulated landing strips. Eleven airlines served Asuncion in 1996; now, just three airlines serve Paraguay -- Paraguay-based TAM Mercosur, Bolivia-based Aerosur, and Brazil-based GOL (Brazil-based Varig, a wholly-owned subsidiary of GOL, also flies to Asuncion). Chilean Airline LAN has a code share agreement with TAM Mercosur but does not operate flights to Paraguay.

¶13. (SBU) Paraguay's small aviation market continues to shrink, and many airlines have exited the market because of low passenger volumes and unprofitability. Paraguay's airports served 381,357 passengers in 2003, down from an average of 520,000 per year in the 1990's. American Airlines served Paraguay for 16 years until January 2006, when it stopped flying to Asuncion. American ceased operations because of a law that went into effect in December 2005 obligating airlines to pay travel agents a six percent commission on tickets sold. (NOTE: Prior to the passage of the tourism law, the government did not regulate commission rates, and airlines paid varying commission rates. END NOTE.) American claimed that both unprofitability and the regional precedent set by the mandated six percent drove it out of the market. However, it recently indicated that it may resume flights to Paraguay by the end of 2007.

¶14. (U) Several airlines recently entered the market or plan to offer flights to Asuncion. GOL started a weekly flight

December 2006 from Asuncion to Sao Paulo. According to Aerosur Sales Director Alberto Cabrera, Aerosur, which recently opened for business in Asuncion and now offers daily flights to Santa Cruz, Bolivia; Buenos Aires; and Sao Paulo, plans to add additional flights from Asuncion not served by TAM Mercosur such as Montevideo and Madrid. He stated that Aerosur plans to offer service from Asuncion to Miami by July 2008, the first direct flight to the United States since American's departure. Cabrera stated that Aerosur focused on developing a decentralized, point-to-point aviation network -- in contrast to TAM's hub-and-spoke network emanating from Buenos Aires and Sao Paulo. Aerolineas Argentinas, in turn, expressed interest in adding an Asuncion-Buenos Aires route, and Brazil-based OceanAir may add an Asuncion-CDE-Sao Paulo-Caracas flight.

MARKET DYNAMICS

¶ 15. (SBU) Several airlines are expanding operations to Paraguay due to the country's intensive lobbying efforts. TAM Mercosur Operations Director Dario Maciel and Commercial Director Javier Hickethier told EconOff August 14 that neither passenger demand nor airport safety had improved in recent years -- in fact, both progressively worsened. Instead, the executives claimed that DINAC actively recruited airlines to enter the market. They stated that then DINAC Chief Tomas Bittar, at Vice President Luis Castiglioni's behest, personally contacted LAN Chile, Aerosur, Ocean Air, and Aerolineas Argentinas to encourage them to operate in Paraguay. Bittar's efforts yielded Aerosur's market entry, a code share agreement between LAN and TAM Mercosur, and a commitment by Aerolineas Argentinas to enter the market by September. Bittar, a close friend and associate of Castiglioni, resigned from DINAC in June to join Castiglioni's presidential campaign.

¶ 16. (SBU) Cabrera confirmed August 16 that regional politics prompted Aerosur's move into the country. The Bolivian government suspended the operations of its flagship carrier, Lloyd Aereo Boliviano (LAB), in April 2007 due to financial insolvency. Aerosur says it now carries over 90 percent of Bolivia's air traffic. Cabrera stated that concerns over Bolivia's nationalization of key industries prompted the company's leadership to shift some assets to its Paraguayan holding company, Aerosur Paraguaya S.A. Cabrera admitted that the company plans to use its Paraguayan operations as a failsafe in the event that the Bolivian government decides to nationalize its civil aviation industry. He stated that Aerosur informed President Evo Morales of its diversification plan to discourage him from targeting the company for nationalization. U.S. Department of Transportation (USDOT) Negotiator Brian Hedberg told EconOff that the Bolivian government planned to relaunch a smaller, nimbler LAB in September 2008 and that Aerosur also faces increased domestic competition from the new LAB and startup airline Aerolinea Sudamericana -- another reason why Aerosur entered the Paraguayan market.

WILL THE AVIATION INDUSTRY CRASH AND BURN?

¶ 17. (SBU) The ICAO advised DINAC in July of its concern over the safety of Paraguay's airports and may issue an advisory opinion in 2008 warning member countries of these safety issues. The ICAO cited the Paraguayan government's failure to address critical deficiencies in its airport infrastructure, air traffic control systems, and security systems -- particularly its broken radar systems and decrepit runways. Although the Paraguayan government has long aspired to transform Asuncion into a major South American airline hub, its airports may not meet some or all of the safety standards outlined in the 16 Annexes of the ICAO's Chicago Convention. The ICAO advised DINAC that unless it addresses these safety deficiencies, it may issue an advisory opinion to member countries in early 2008 indicating that Paraguay

failed to meet ICAO standards. (NOTE: Cecilia Capestan of the U.S. Federal Aviation Administration's (FAA) Western Hemisphere Office told EconOff that each airline carrier and member state -- notably Argentina, Bolivia, and Brazil -- would have to weigh the ICAO's opinion and decide whether to respond to it. Increased aviation scrutiny in Brazil following the TAM airliner crash in Sao Paulo July 2007 and an adverse ICAO opinion of Paraguay's safety standards could prompt some airlines to consider scaling back or suspending local operations. END NOTE.)

¶8. (SBU) Reacting to the ICAO's warning, TAM Mercosur executives demanded that DINAC repair key airport infrastructure and equipment. In an official memorandum, TAM cited non-existent radar and visual guidance systems, unresponsive non-directional beacons (NDBs), faulty ground-to-air communication systems, malfunctioning runway lighting, and subpar runways that serve as thoroughfares for unauthorized individuals, dogs, and fowl, as problems with Asuncion's airport. TAM executives affirmed that Asuncion's runways have not been resurfaced since 1964 and have been repeatedly patched, exposing cracks, fissures, and uneven pavement.

¶9. (SBU) Lax security controls -- exacerbated by corruption and bribes -- expose Paraguay's airports to security threats by terrorists, armed robbers, and traffickers. Gunmen stole USD 1.2 million July 31 from two currency exchange service employees transiting through the Asuncion airport. In a separate incident in August 2000, eight gunmen disguised as soldiers stole USD 16 million from security guards loading the currency onto a TAM aircraft. TAM executives told EconOff that evidence from the 2000 robbery pointed to involvement by high-profile Paraguayan officials, indicating a high level of sophisticated corruption and the systematic targeting of airports for robberies and drug and contraband transshipments. More frequently, thieves pilfer travelers' checked-in luggage.

PARAGUAY'S RESPONSE

¶10. (U) Paraguay's aviation regulatory agency submitted a plan to the Finance Ministry to upgrade its airports. EconOff met DINAC President Colonel Eduardo Miers, Operations Security Chief Colonel Pablo Maldonado, and Director Ceferino Farias August 14. Miers stated that DINAC hired Spanish contractor Indra December 2006 to renovate Asuncion's airport operations. Based on Indra's recommendations, DINAC submitted a proposal to the Finance Ministry requesting USD 22 million to improve infrastructure, air traffic control systems, security, and personnel training. The improvements, if implemented, would help the country's airports satisfy the ICAO's safety standards. Miers stated that Congress must approve the funds and has not yet set a timetable for approval. According to Indra Representative Jose Luis Galindo, renovations would not begin until mid-2008, even if Congress approves the funds expeditiously. (NOTE: The proposed 2008 DINAC budget allocates USD 7.7 million for capital funding, including USD 2 million for the Asuncion airport and USD 900,000 for the Ciudad del Este airport. The budget does not include funds to adequately upgrade the airports' infrastructure and systems. END NOTE).

¶11. (SBU) Miers also reported that DINAC approached the FAA seeking permission for commercial aircraft to fly directly from Paraguay to the United States. Although Paraguay and the United States signed an Open Skies Agreement in 2005, Paraguay's airports must meet the FAA's Category I safety standards before direct flights can resume (NOTE: The FAA downgraded Paraguay from Category I to Category II in March 2004. END NOTE). Miers confirmed that he met with FAA and USDOT officials in Santa Cruz in July and discussed upgrading Paraguay from Category II to Category I. USDOT Negotiator Hedberg expressed skepticism that the USDOT would upgrade Paraguay to Category I in the near term and that USDOT would likely reject Aerosur's application to initiate direct

flights to Miami from Asuncion because it is not a sovereign Paraguayan carrier.

COMMENT

¶12. (SBU) The upcoming election season could increase interest in Paraguay's airport deficiencies and give DINAC an opportunity to improve airport safety. DINAC and airport officials seem genuinely concerned that an adverse ICAO advisory opinion could impact airport operations, perhaps prompting airlines to cease or scale back operations.

However, the Finance Ministry's failure to push through DINAC's safety improvement funding request indicates that the Paraguayan government has not yet prioritized airport safety.

Even if Congress approves the funds to improve airport safety, DINAC's planned upgrades would not adequately address the airports' vulnerability to security threats. Embassy is working with DINAC to see where it can work to improve airport deficiencies.

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